Market shifts gears from inflation to growth

After a sharp risk-off tone heading into August, a recovery in sentiment has helped push equity prices and bond yields back up again. A tame US inflation report[1] followed by an uptick in US unemployment[2] has raised concerns that as with inflation back in 2021, the US Federal Reserve (Fed) may fail to pre-empt a recession. Elsewhere, it took a 15bp rate hike by the Bank of Japan for Japanese stocks to plunge and the JPY to surge, upending "carry" trades which borrow cheaply in JPY to buy foreign higher-income assets.

While more incremental than dramatic, this normalisation in economic data and policy seems blown out of proportion by technical factors, such as vulnerably low levels of market volatility and trading volumes, as well as the unwinding of crowded trades. Despite the softer jobs report for July, the unemployment rise was mostly due to more people entering the workforce. And while Q2 corporate results have been more tempered so far, with some companies citing lower demand on higher prices, reported earnings are not bad. We continue to see a soft landing as our base case, and any piecemeal deterioration in data as simply tempering the odds of a "no landing" scenario where the US economy continues to go from strength to strength. There is still some way to go as other US jobs data is holding up. The non-farm job openings rate held at 4.9% in June, the highest level since 2000, excluding the period of post-Covid economic reopening when it peaked at 7.4% in 2022.[3]

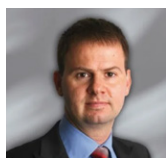
We think this latest market tantrum, however sentiment-driven, should not be downplayed since it stands to accelerate the market's shift in gears from inflation-led to growth-led. Futures markets now like the odds for a -50bp Fed rate cut in September, and a reduction of up to -1.25bp in the Fed Funds rate by the end of this year – which is double what was priced in a few weeks ago.[4]

The risk-off tone into August benefited global fixed income and lent support to yield-curve slopes turning positive. Still, historically it is not until after rate cuts begin in earnest that we tend to see more sustained curve steepening. In our view, outsized moves in yields and yield-curve slopes create opportunities to tactically take some profits on recent long duration and steepening trades (excluding Japan) and recalibrate

Fixed income market performance

Indicative market indices Data as of 31 July 2024	Total return YTD 2024 (%)	Total return July 2024 (%)	Yield-to-worst* (%)	Effective duration (years)
Asian high yield	12.14	1.47	11.9	2.5
Global convertible bonds	5.39	1.17	0.5	1.9
US high yield	4.65	2.00	7.6	3.2
Euro high yield	4.43	1.27	6.3	2.8
Global emerging-market sovereign bonds	4.26	1.87	8.2	6.6
US floating-rate notes	3.95	0.51	5.9	0.0
Asian investment grade	2.91	1.30	5.2	4.7
US Treasury bonds 1-3 years	2.34	1.19	4.3	1.7
Euro investment grade	2.27	1.72	3.5	4.6
Global aggregate	2.07	1.93	3.6	6.6
US investment grade	1.89	2.38	5.1	7.2
US aggregate	1.61	2.34	4.6	6.2
Euro government bonds 1-3 years	1.20	0.87	2.8	1.9
Global government bonds AAA-AA	0.84	2.11	3.1	7.7
Euro aggregate	0.80	2.04	3.0	6.6

Source: Bloomberg, ICE BofA and JP Morgan indices; AllianzGI, data as at 31 July 2024. Index returns in USD-hedged except for Euro indices (in EUR). Asian and emerging-market indices represent USD denominated bonds. Yield-to-worst adjusts down the yield-to-maturity for corporate bonds which can be "called away" (redeemed optionally at predetermined times before their maturity date). Effective duration also takes into account the effect of these "call options". The information above is provided for illustrative purposes only, it should not be considered a recommendation to purchase or sell any particular security or strategy or as investment advice. Past performance does not predict future returns.



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portfolio positions. But strategically we stay constructive on fixed income.

It's fair to assume we should see a continued market build-up to a Fed rate cut in mid-September. However, the pace of Fed cuts that follow afterwards is a more open-ended question. A second rate cut by the European Central Bank (ECB) in September also looks to be on the agenda. We don't see that as a done deal yet, as geopolitically fuelled upside risks to inflation will be weighed against new data and projections on the euro area economy's recovery path.

Meanwhile, high-quality credit has held up better than equities, with strong demand into the end of July. While spread volatility spiked too at the beginning of August, investment-grade and high-yield spreads remain tight compared to long-term averages, with European spreads running slightly wider. Further widening down the line would present better opportunities to bid for risk. In addition to the technical picture of corporate issuance getting absorbed comfortably by flows, timely rate cuts may also extend this credit cycle further with looser financial conditions and lower, but still positive, economic activity.

We would be remiss not to mention two relatively under-owned asset classes which continue to perform resiliently despite a choppy geopolitical and interest-rate backdrop. Year-to-date, USD-denominated emerging market sovereign debt and Asian credit remain the top-performing sovereign and corporate debt categories, respectively, with attractive yields and improving fundamentals anchoring returns.

WHAT TO WATCH

1 US jobs & inflation data

The latest weekly US jobless claims were lower than expected[5] and that helped ease concerns somewhat about an abrupt economic slowdown. However, this data series can be volatile and heavily impacted by seasonality. Two crucial monthly reports to watch before the Fed delivers a rates decision in mid-September are personal consumption expenditures (30 August) and non-farm payrolls (6 September).

2 Japan yields & curve

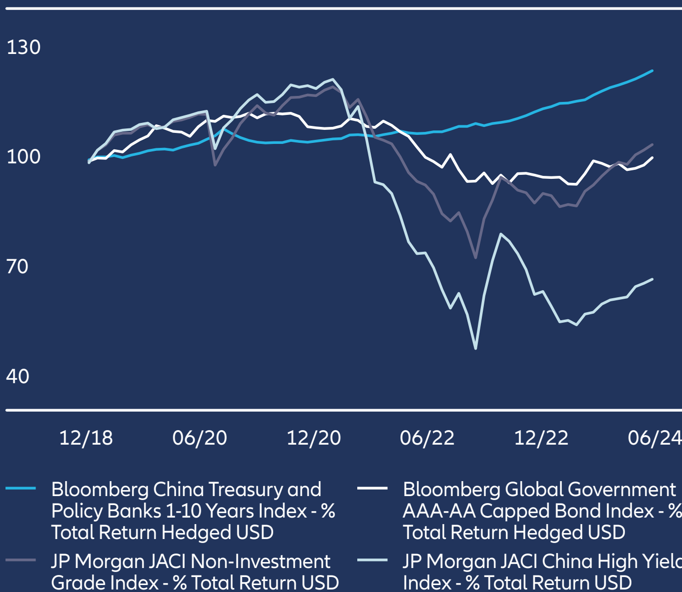
Following the market turmoil that came after the Bank of Japan hiked its rate to 0.25% and announced plans to taper monthly bond purchases, the central bank took note of the volatility and signalled that it would not rush into further hikes in the near term. Despite this about-turn, there is more room for Japanese government bond yields to rise and for further flattening across the yield curve (Japan still has the steepest curve in the G10).

3 US election & Middle East

The upcoming US elections and a Middle East conflict can impact markets, but we would caution against drawing outright investment conclusions. Democrats and Republicans have varying approaches to trade, taxes and foreign policy, but US debt is likely to keep growing under either administration. In the Middle East, the recent escalation is having a more muted effect on oil as other energy sources grow in relevance.

CHART OF THE MONTH

China rates and Asian high yield



Source: Bloomberg and JP Morgan indices, Allianz Global Investors; cumulative total return (%) rebased to 100 from 31 December 2018 to 31 July 2024. Past performance does not predict future returns.

With market attention turned squarely on policy shifts in core rates markets, it's also worth highlighting the diversification role of China rates exposure in global fixed income portfolios. In recent years, China government bonds (CGBs) have grossly outperformed the highest-rated government bonds in aggregate, on a USD-hedged basis. Whilst core rates (excluding Japan) are now well-positioned to play catch-up, exposure to CGBs coupled with cost-efficient FX-hedging strategies can continue to benefit from an extended period of loose monetary conditions – as evidenced by the latest series of rate cuts from China's central bank. These easing measures and ongoing restructuring of China's property sector has partially contributed to the strong comeback of Asian high-yield (HY) USD credit. Year-to-date index returns were just above 12%, adding to 2023's 4.75% gain, and bringing cumulative returns since end-2018 above AAA-AA rated global government bonds. But the widening performance gap in pan-Asia vs. China HY markets shows there is more to Asian HY than China and real estate, with compelling opportunities in other countries and sectors too.

* Represents the lowest potential yield that an investor could theoretically receive on the bond up to maturity if bought at the current price (excluding the default case of the issuer). The yield to worst is determined by making worst-case scenario assumptions, calculating the returns that would be received if worst-case scenario provisions, including prepayment, call or sinking fund, are used by the issuer (excluding the default case). It is assumed that the bonds are held until maturity and interest income is reinvested on the same conditions. The yield to worst is a portfolio characteristic; in particular, it does not reflect the actual fund income. The expenses charged to the fund are not taken into account. As a result, the yield to worst does not predict future returns of a bond fund.

1. US Bureau of Economic Analysis, Personal Consumption Expenditures Price Index, 26 July 2024.
2. US Bureau of Labor Statistics, Employment Situation Summary, 2 August 2024.
3. US Bureau of Labor Statistics, The Economics Daily, 2 August 2024.
4. CME FedWatch, 8 August 2024.
5. US Department of Labor, Unemployment Insurance Weekly Claims, 8 August 2024.

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